THE INCOME-TAX AMENDMENT

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POLITICAL SCIENCE QUARTERLY

VOL. XXV., No. 2, JUNE 1910

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THE question of the income-tax amendment of the federal Constitution is now before the country. The general movement in favor of its ratification by the state legislatures has suffered a serious set-back through the opinion expressed by the governor of the state of New York. In his judgment, the power to levy an income tax ought assuredly to be given to the national government, but the amendment proposed by Congress labors under the fatal defect that it would empower the federal legislature, by taxing state and municipal bonds, to strike at the very vitals of state credit and state independence.

Governor Hughes is so excellent a lawyer and so great a statesman that his opinion is not lightly to be controverted. But in my judgment it is erroneous in three respects:

(1) His interpretation of the legal force of the amendment is incorrect.

(2) Even were his legal interpretation correct, he fails to take account of economic facts which would prevent the consequences which he fears.

(3) Even were his view correct, that the constitutional amendment would operate to change the law in the direction indicated, there are valid reasons why the law should be so changed and the amendment prevail.

Let us take up each of these points in order.

I

A long series of decisions has established the doctrine that there are limitations implied as well as express upon the power of taxation, both of the federal and of the state governments.

In the case of McCulloch *v.* Maryland,[1] decided in 1819, it was held that a state tax on the Bank of the United States was unconstitutional. Chief Justice Marshall, in this case, stated:

That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance in conferring on one government a power to control the constitutional measures of another, which other, with respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied. . . . The states have no power, by taxation or otherwise, to retard, impede, burthen, or in any manner control, the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the general government.

A few years later, in 1824, the same proposition was advanced in the case of Osborn *v.* United States Bank.[2] The next step was taken in 1829, when, in the case of Weston *v.* Charleston,[3] a local tax on federal bonds was declared unconstitutional. The court said:

The tax on government stock is a tax on the contract, a tax on the power to borrow money, on the credit of the United States, and consequently repugnant to the Constitution. . . . The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised and have a sensible influence on the contract. The extent of this influence depends upon the will of a distinct government. To any extent, however inconsiderable, it is a burthen on the operations of government.

Again, in 1842, in the case of Dobbins *v.* Commissioners of Erie County,[4] it was held that a local tax was invalid so far as the salaries of federal officers were concerned. And finally, in 1862, in the case of Bank of Commerce *v.* City of New York,[5] it was decided that a state tax on the capital stock of a bank, when such capital stock consisted, in whole or in part, of United States bonds, was unconstitutional.

Beginning at a later period, another series of decisions declared that the federal government was likewise restrained from taxing state operations and agencies. In the case of Collector

[1] 4 Wheaton, 316. [2] 9 Wheaton, 738 [3] 2 Peters, 449.
[4] 16 Peters, 435. [5] 2 Black, 620.

v. Day,[1] decided in 1870, the federal civil-war income tax was held to be unconstitutional so far as it applied to the salaries of state judicial officers. The court said:

It is admitted that there is no express provision in the Constitution that prohibits the general government from taxing the means and instrumentalities of the states, nor is there any prohibiting the states from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implication, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can only exist at the mercy of that government. Of what avail are these means if another power may tax them at discretion?

In United States *v.* Baltimore and Ohio Railroad Company,[2] decided in 1872, it was held that the United States government cannot tax "the agencies and instruments" of the states. In Mercantile Bank *v.* New York,[3] decided in 1886, which held that a state tax on the shareholders of national banks was valid for special reasons, not necessary here to discuss, it was stated, although indeed *obiter,* that bonds issued by a state, "or under its authority by its public municipal bodies, are means for carrying on the work of government, and are not taxable even by the United States." And finally, in Pollock *v.* Farmers' Loan and Trust Company,[4] decided in 1894, the foregoing dictum was cited with approval, and it was distinctly held that a tax upon incomes from municipal bonds was unconstitutional. The court said:

It was long ago determined that the property and revenues of municipal corporations are not subjects of federal taxation. The same want of power to tax the property or revenue of the states or their instrumentalities exists in relation to a tax on the income from their securities.[1]

It is accordingly an established rule of constitutional interpretation that state and municipal bonds are not subject to federal taxation.

The question which now confronts us is: Will the adoption of the proposed amendment change this situation? The amend-

[1] 11 Wallace, 113.
[2] 17 Wallace, 322.
[3] 121 U. S. 138.
[4] 157 U. S. 429.

ment states that Congress "shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." What does this mean? It is obvious that the government now has power to levy an income tax; but in attempting to levy such a tax it is met by those provisions of the constitution which declare, first, "that no capitation or other direct tax shall be laid unless in proportion to the census or enumeration hereinbefore directed to be taken," and secondly, that "representatives and direct taxes shall be apportioned among the several states according to their respective numbers." If these provisions apply to the taxation of income, they mean that if state A, with the same population as state B, has five times the wealth, the income tax payable by a citizen of state B will be five times as large as that payable by an equally wealthy citizen of state A. So monstrous an inequality would, of course, prevent Congress from imposing an income tax as a direct tax. To make a federal income tax practicable, it is necessary either to declare it to be an indirect tax —the sole restriction as to which is that it shall be uniform— or expressly to permit the levying of an income tax without apportionment.

For many years the income tax was supposed to be an indirect tax in the sense in which the term is used in the Constitution. Toward the close of the War of 1812 the Secretary of the Treasury brought in a scheme for an income tax, and, had peace not been suddenly declared, the scheme would have been adopted. Many signers of the constitution were still living, and no one raised the objection that the income tax was direct in the constitutional sense. During the Civil War an income tax was levied, and in the first cases adjudicated it was upheld. Taking each of these cases as decisive only of the precise question before the court, it was settled in Pacific Insurance Company *v.* Soule[1] that a tax on the premiums received by an insurance company is not a direct tax, and in Springer *v.* United States[2] that a tax on the income which an individual derives in part from professional earnings and in part from the

[1] 157 U. S. pp. 584, 585.

[2] 102 U. S. 586 (1880).

interest on bonds is not a direct tax. In the Pollock case,[1] on the other hand, it was decided that a tax on the income from real estate is a direct tax, valid only when apportioned, while a tax on municipal bonds was declared to be, like a tax on the salaries of state officers, entirely invalid for lack of power to impose it.

The Supreme Court of the United States has thus held that certain kinds of income taxes are indirect, that certain other kinds of income taxes are direct, and that still other kinds of income taxes are invalid, irrespective of whether they are direct or indirect. So far as the first two classes are concerned, therefore, the court has stated the law to be that a tax on incomes from certain sources, being direct, can be levied only through apportionment, and that a tax on incomes from other sources, being indirect, can be levied without apportionment. The object of the pending constitutional amendment is simply to remove this discrimination and to make it possible to tax incomes without apportionment, whether the sources of the incomes are regarded as falling within the one category or the other. That is, the amendment declares that an income tax can henceforth be levied without apportionment, no matter what the source may be, *i. e.*, no matter whether the source is one that at present necessitates apportionment or one that at present does not necessitate apportionment. When the amendment states that the government shall have power to levy a tax "on incomes, from whatever source derived, without apportionment," chief emphasis is to be put upon the words "without apportionment." The words "from whatever source derived" are indeed no mere surplusage.[2] On the contrary, their real import is to remove the existing discrimination between the various sources of income, so far as apportionment is concerned, and to put those sources which, under the existing interpretation, can be taxed only through apportionment in the same category as those sources which can now be taxed without apportionment. To say "from whatever source derived" is simply another way of saying "irrespective of the source," or a shorter way of saying

[1] 157 U. S. 429 (1894).

[2] 7 Wallace, 433 (1868).

"from all sources alike, whether the source be one that previously made apportionment necessary or not." So that the amendment is equivalent to the statement that "Congress shall have power to lay and collect a tax on incomes, whether previously laid by apportionment or not, without apportionment." It is accordingly a mistake to assume that the words "from whatever source derived" give the government the power to tax the income from state or municipal bonds, for such a tax falls within the third category of income taxes mentioned above as being entirely beyond the taxing power of the federal government.

This has been clearly recognized by the Supreme Court. In the Pollock case[2] it was expressly held that the objection to the taxation of municipal bonds was lack of power on the part of the general government to interfere with the operations of state government.[3] When the Pollock case was reheard,[4] the court said, in reference to the grounds of the decision in the original hearing: "As to the income from municipal bonds, that could not be taxed because of want of power to tax the source, and no reference was made to the nature of the tax as being direct or indirect."[5] Both on the original hearing and on the rehearing, dissenting opinions were read, but on the point which we are now considering there was no dissent. Justice White said:

> The decisions of this court, holding that the federal government is without power to tax the agencies of the state government, embrace such bonds [*i. e.,* those of municipal corporations] . . . . Where there is no power to tax for any purpose whatever, no direct or indirect tax can be imposed . . . . The levy, whether direct or indirect, is beyond the taxing power.[1]

Justice Harlan, who concurred with the views expressed by Justice White, added: "It is immaterial to inquire whether the

[2] 157 U. S. 429.
[3] *Ibid.* pp. 584, 585.
[4] 158 U. S. 601.
[5] *Ibid.* p. 618.
[1] It is here that I venture to differ from the position taken by Senator Root in his letter to Senator Davenport of New York on the income tax. The present article, it may be well to state, was written before the appearance of Senator Root's letter.
[1] 157 U. S. 652.

tax [on the income of municipal bonds] is, in its nature or by its operation, a direct or an indirect tax; for the instrumentalities of the states . . . are not subjects of national taxation in any form or for any purpose."[2] And Justice Brown stated that a tax upon the income of municipal bonds was, in his opinion, a "tax upon something which Congress has no right to tax at all, and hence is invalid. Here is a question, not of the method of taxation, but of the power to subject the property to taxation in any form."[3]

It is clear, therefore, that a change in the method of assessing an income tax from that of apportionment to that of direct levy, cannot make any difference as to the power of the government to tax the income of state or municipal bonds. If the federal government is precluded by the very nature of the constitutional pact, as we are told in Collector *v.* Day,[4] from imposing any tax on state agencies, power to do this will not be conferred upon it by an amendment which simply changes the method of levying a particular kind of tax. What is now non-taxable will remain non-taxable. A change in the method of taxation does not constitute a change in the subject of taxation.

Any other interpretation of the amendment, moreover, would result, in the event of its adoption, in a situation which may well be characterized as absurd. The existing inability of the federal government to tax the property of a state or the instrumentalties of its government will of course continue, for the amendment clearly does not empower Congress to tax property as such. If it were to be held that the amendment gave the federal government power to tax the income of state bonds, we should then have the awkward result that the federal government could not tax the bonds themselves but could tax the income from the bonds. Or, to take a still more absurd case, if a state or municipality possessed some revenue-yielding property, like a piece of real estate, it would be competent for the federal government to tax that real estate if it assessed the tax *eo nomine* on the income, while it would be incompetent for the federal government to tax the real estate if the tax were levied on the property as such. In view of the fact that the market value of any piece

[2] *Ibid*, p. 654.

[3] 158 U. S. 693.

[4] 11 Wallace, 113.

of property is due only to its present and prospective income, it will readily be perceived in what a maze of contradictions we should be involved by the acceptance of so strained an interpretation of the amendment. When two interpretations of a clause are possible, of which the one is not only, as the Supreme Court has asserted, in direct opposition to the spirit of the Constitution but is also calculated to bring about the most awkward practical situation, while the other is in complete harmony with the trend of judicial decisions and at the same time is likely to obviate all fear of fiscal contradictions or complications, is it not reasonable to assume that the court will prefer the second and more natural interpretation? Such an interpretation is the one which puts the emphasis on the words "without apportionment" and regards the amendment as legalizing a change simply in the method of levying the tax—a change from apportionment to direct assessment.

We are, therefore, justified in concluding that the essential character of the implied restrictions in the constitution will not be altered one whit by the amendment. State and municipal bonds will henceforth, as before, be exempt from federal taxation, whether the tax be imposed on the property, or whether it be imposed on the income from the property.

II

If now, for the sake of argument, it be assumed that the contrary view is legally correct, and that the effect of the proposed constitutional amendment would be to legalize the taxation of state and municipal bonds, it may still be shown that the consequences mentioned in the message of Governor Hughes would not follow. We are told that the amendment might "place the borrowing capacity of the state and of its governmental agencies at the mercy of the federal taxing power," and that it might "place such limitations upon the borrowing power of the state as to make the performance of the functions of local government a matter of federal grace."

This opinion, as I hope to show, is erroneous, and the error is traceable to the lack of an adequate economic analysis on the

part of the governor—an analysis indeed, which is equally absent from the legal decisions which have misled him. In other words, even if the governor's law be sound, his economic reasoning is unsound, and his final position is still untenable. Let us leave, for a time, the whole domain of legal contention and discuss the question of the economic effect of the amendment.

The objection to a tax on governmental securities rests on the presumption that their market value will be affected by the tax. As the Supreme Court said in 1829, in Weston *v.* Charleston:[1]

> The tax on government stock is a tax on the contract, a tax on the power to borrow money, on the credit of the government. . . . The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract.

Of course this sensible influence on the contract can register itself only in the lower market price of the securities. This is the result of the familiar economic principle known as the capitalization or amortization of taxation.

The theory of the capitalization of taxation is, in effect, that when a recurring tax of virtually the same amount is imposed upon the capital or selling value of some durable or permanent property, the selling value of that property will be reduced by a sum equal to the capitalization of the tax.[2] If, for instance, the normal rate of interest on securities is five per cent, and a five-per-cent bond has been selling at par, and if a new tax of one per cent per annum be imposed upon that particular class of securities, the price of the bond will fall from 100 to about 80.[3] The new purchaser of the bond will net only

[1] 2 Peters, 449.

[2] The whole subject of the capitalization of taxation is fully treated in Seligman, The Shifting and Incidence of Taxation (3d ed., 1910).

[3] As a matter of fact, whether the price of the security upon which the new tax is imposed will fall exactly to 80 depends very largely upon the amount of these securities, compared with the total amount of capital in the country. If the amount of these newly taxable securities is comparatively large, the price will not fall quite to 80, but perhaps only to 81; for the imposition of a tax on so large a part of the outstanding capital of the

four dollars on the hundred, since he has to pay one dollar in taxes. If, however, he can look forward to a net return of only four dollars, and if the general rate of interest still remains at five per cent, he will naturally pay only eighty dollars for that bond. There is no reason why he should pay more, since he can continue to invest his money in enterprises which are not taxed and which will still net him five per cent. In other words, the annually recurring tax of one per cent will be capitalized into a sum which is automatically deducted from the market value of the securities, thus bringing about an amortization of these securities. At any given time the discrepancy between the taxed and the untaxed securities will be precisely such as to make the net income from each equal the normal rate of interest, and the difference in the market value of the two classes of securities will always be exactly equal to the capitalization of the tax.

The influence of tax exemption is the very reverse of that exercized by taxation. If all securities have hitherto been subject to taxation, and if one particular class of securities be suddenly exempted, the value of these tax-exempt securities will rise by an amount equivalent to the capitalization of tax. If five-per-cent bonds which, like all other forms of capital that are subject to a tax of one per cent, sell at par, it means that the normal rate of interest is four per cent, since investors net four dollars on every hundred dollars. If this particular class of bonds be now exempted from taxation, the price of the bonds will appre-

country will probably have an influence, even though slight, on the general rate of interest and may reduce that general rate from five per cent. to perhaps four and seven-eighths or four and fifteen-sixteenths. If a large amount of capital is transferred from these newly taxed bonds or other securities, the increasing demand for these other securities, previously selling at par, will enhance their price to a little above par. As, however, the net return on these other securities remains at five dollars, this is equivalent to saying that the rate of interest on the investment will now be a little below five per cent. If the general rate of interest falls to a little below five per cent., the market value of the taxed securities will now be a little over 80. If, as is usually the case, the taxed security forms only an insignificant part of the whole amount of capital, the influence on the general rate of interest will be inappreciable. and the price of the security will fall to 80.

ciate to 125, since five dollars bear the same relation to $125 as four dollars do to $100. Thus, whatever way we look at it, taxation will diminish the market value of bonds just as exemption will increase their market value.

Where an annual tax is actually enforced, and where other conditions remain the same, the difference between taxable and non-taxable securities is indeed precisely in accord with the capitalization theory.[1] In the United States, however, the influence of taxation is sensibly modified by prevailing conditions, and the discrepancy between taxable and non-taxable bonds is far less than might be expected. The rate of the local property tax varies in the United States from one and one-half per cent to over two per cent. Let us take two per cent as the normal figure. Let us also assume that the current rate of interest is four per cent, so that four-per-cent bonds will sell at about par. If there were no property tax, and if these bonds were now subjected to the two-per-cent tax, they would manifestly fall to 50, since one-half of their yield would be eaten up by the tax. If, on the other hand, we take the actual law under which all property is taxable at the rate of two per cent, then if the four-per-cent bonds were exempted from taxation their price on the market ought to rise from par to 200; for instead of the holder netting two dollars on each one hundred dollars (four dollars interest minus two dollars tax), he would now net four dollars, or double the amount. A doubling of the income, however, would involve a doubling of the market value.

As a matter of fact, the disparity between taxable and tax-exempt securities in our American states falls far short of reaching this point. This is true not only of exemption from a special tax but, and in still larger measure, of exemption from

[1] An excellent illustration is found in the mortgage bonds of the Northern Railway in France, part of which are issued on its French line and part on the Belgian stretch, although the security is the same in both. In the case of the bonds on the French stretch, however, a special tax is imposed and levied up to the hilt by the French government. In the case of the securities on the Belgian stretch there is no such tax. The difference in the market price of the bonds, on the Paris stock exchange, is exactly equivalent to a capitalization of the French tax. *Cf.* Edgar Milhaud, L'Imposition de la rente (1908), pp. 29, 30.

a general tax. A good example of the influence of a special exemption is afforded by the New York state canal bonds.[1] When these bonds were authorized, to provide for the enlargement of the Erie canal, the constitutional amendment limited the rate of interest to three per cent. By the time that it had become necessary to issue the bonds, the market had fallen to such a point that they were not salable, and in order to change the rate another constitutional amendment became necessary. To arrange for the state finances in the interval, a law was passed granting to the three-per-cent bonds a special exemption of one per cent, to be applied against the franchise tax of similar amount, payable by savings banks, trust companies and insurance companies. The three-per-cents, as a result, sold around a 2.90-per-cent basis, and the four-per-cents around a 3.45-per-cent basis. Even here, therefore, the difference in the price of the bonds was only about one-half of the capitalization of the tax.

The case of general exemption is illustrated in Massachusetts. In that state all municipal bonds issued after May 1, 1908, are exempt from taxation. The old taxable three-and-one-half-per-cent Boston bonds sold in 1910 in Massachusetts on about a 3.80-per-cent basis, the new tax-exempt bonds sold on about a 3.40-per-cent basis, *i. e.,* at 101.83 as compared with 94.76. The tax rate was about 1.65, almost one-half of the income of the bonds. In other words, a tax exemption of almost fifty per cent of income made a difference of only seven per cent in selling value. Even this difference, moreover, is largely due to the fact that the chief purchasers of Boston bonds are the Massachusetts savings banks, which are subject to a fixed tax of one-half of one per cent—a tax that is collected with comparative efficiency.

Where the bonds command a wider market, the influence of tax exemption is naturally far less marked, because the exemption applies only within the state. In Pennsylvania, for instance, bonds are subject to a tax of four mills on the dollar,

[1] For many of the facts in this section I am indebted to the courtesy of Mr. McKee, of Messrs. N. W. Harris and Company, of New York City, one of the largest American houses dealing in state municipal securities.

and some corporations and municipalities pay the tax without deducting it from the interest. In the case of the smaller municipalities, whose bonds are sold only locally or within the state, this tax produces a difference in price between taxable and tax-exempt bonds, but a difference that is far less than a capitalization of the tax. In the larger cities, however, like Philadelphia, Pittsburg and Scranton, where the bonds are a legal investment for New York savings banks and thus reach a wider market, the difference in value is exceedingly slight. A bond which sells on a 3.90-per-cent basis, tax-exempt, would in such cases, if taxable, sell only on about a four-per-cent basis. In the case of general corporate securities which have a still wider market, the difference due to tax exemption is almost inappreciable. A taxable security selling at 100 will frequently compare with a tax-exempt security at 102 or 103—a difference which, when spread over the years prior to the maturity of the bond, represents only the merest fraction of the four-mills tax.

In most of the states, however, the tax rate is not four mills, as in Pennsylvania, but, as stated above, from one and one-half to two per cent. Even where a serious attempt is made to enforce the personal property tax, as in Ohio, with its tax-inquisitor law, the only result is that tax-exempt bonds — Cincinnati bonds, for instance — sell on a 3.80-per-cent basis in the local market, while in the general outside market they would sell at a lower price—namely, on a 3.90 or 3.95-per-cent basis. The actual tax, or the risk of taxation of two per cent, hence means a difference of only a few points in the value of the securities.

Even within the area of tax exemption, the larger the amount of the tax-exempt securities, the smaller will be the difference in value between them and the taxable securities. In New York, for instance, so long as tax-exempt bonds were rare, they commanded somewhat of a premium: the New York City two-and-one-half-per-cent bonds at one time sold above par, because they were much sought after by trustees of trust estates who were desirous of escaping the burdensome local tax. Since 1908, however, all municipal bonds are exempt from general taxation throughout the state; and the result has been a progressive disappearance of the difference in price between taxable and

tax-exempt bonds. Of course two other factors have been coöperating; the one, that the market in New York City bonds now transcends the capacity of New York City investors; the other, that the assessment of taxable securities in the hands of individuals, under the local general property tax, is becoming even more infrequent than it was formerly. Undoubtedly, however, the chief factor in the progressive elimination of the premium on tax-exempt bonds is the increase in their quantity. It is instructive to note how, through the inevitable operation of economic law, the very multiplication of tax-exempt state and municipal bonds is gradually defeating the object of the exemption. The greater the area of tax exemption, the less does its influence become.

It appears, accordingly, that, under present American conditions, exemption from a tax which in some cases amounts, nominally, to twenty-five or even fifty per cent of the income of the bonds actually makes no difference in their market value, or a difference so slight as to be negligible. This at least is the result of the exemption of state and municipal bonds from the general property tax, as levied in the American states. Let us now consider the bearing of this fact upon the results to be anticipated from the imposition of a federal income tax.

The income tax contemplated by the constitutional amendment is very different from the general property tax. A general property tax of two per cent is, we have seen, equivalent to a fifty per cent income tax, if the prevailing rate of interest is four per cent. The federal income tax of 1894 provided for a tax, not of fifty per cent, but of two per cent. If a tax of fifty per cent makes, as we have seen, virtually no difference, what significance can we ascribe to a tax of two per cent? Even if we assume that a federal income tax will be more effectively enforced than a state general property tax, the margin is still so enormous as to rob the income tax of much of its supposed danger. The practical effect of subjecting the income of state or municipal bonds to federal taxation would be so slight as to render the tax virtually innocuous.

We come now, however, to the central point of the argument. In the entire preceding discussion we have assumed the ex-

istence of an exclusive tax or of a special exemption. The theory of capitalization or amortization applies only in such cases. If a special tax is permanently imposed on a class of property, it can be capitalized, because of the existence of a taxless field to which the taxpayer can repair and in which he can invest his money. If a special class of property is exempt from taxation, the influence will be felt only because the exemption applies to it alone, and not to other classes of property. But if the tax applies to all classes of property alike, there can be no amortization; and if the exemption applies to all classes alike, there can be no capitalization. The very basis of the theory is the exclusiveness or uniqueness of the proceeding. When a tax is a general tax and not an exclusive tax, the theory ceases to apply.

Now the income tax contemplated by the amendment is not a special tax but a general tax. By the very terms of the amendment, it applies to all kinds of income from whatever source derived. This is the true purpose of the measure. It is conceded that if a special tax were imposed *eo nomine* on state and municipal bonds, it would, theoretically at least, have some influence on their market value, although, as we have seen, the practical effect of such a tax would be less than might be expected. But if incomes derived from state bonds are taxed at the same rate as incomes from other bonds, how can the tax have any influence on their value? There is no taxless field to which the bondholder can repair if he seeks to make a different investment. In whatever kind of property he puts his capital, his income will be equally diminished by the tax. But if all incomes are equally diminished, there can be no change brought about in the relative superiority or inferiority of the different sources of income. If five-per-cent government bonds are selling at par, and if a general income tax of one per cent is imposed on all incomes, the price of government bonds as compared with other securities in general will not be affected one iota. We may go further and say that there will be no change at all in the actual values of any securities, unless the tax is so high as to cause a perceptible exodus of capital to foreign countries, with a resulting slight change in the domestic rate of in-

terest, which change in the rate of interest would, of course, reflect itself in the market values of the securities.

The ordinary view is to be traced to the adoption by the Supreme Court of what it mistakenly conceived to be the opinion of Chief Justice Marshall. In explaining the decision of the court in Weston *v.* Charleston, Chief Justice Marshall said: "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised and have a sensible influence on the contract." And again: "To any extent, however inconsiderable, it is a burthen on the operations of government." This reasoning, in these very terms, was applied in the Pollock case to the federal income tax. It is evident, however, that this application is erroneous; for if the tax is a part of a general income tax there can be no capitalization and no change in the value of the bonds, and hence it cannot "operate on the power to borrow" and cannot "be a burthen on the operations of government." Marshall's statement was justified, in the case which he had before him, for two reasons: first, because the tax in question was, in part at least, *eo nomine* on government bonds, and secondly, because it was a state tax on federal securities. In the Pollock case, however, not only was the court discussing a federal tax on state bonds, but the tax in question was a general tax. Passing over, for the moment, the distinction between a state tax on federal securities and a federal tax on state securities, which will be treated below, the difference between a special tax and a general tax is in itself sufficient to show that Marshall's reasoning does not apply to the Pollock case. In this latter case, the failure of the court to estimate the inexorable operation of economic law led it astray; and implicit reliance on the economic views of our later jurists has misled so eminent a statesman as Governor Hughes.

We may accord the fullest authority to the legal reasoning of the Supreme Court; but when a legal conclusion is based on an economic argument which is plainly fallacious, it is time to call a halt. In this instance the economic reasoning of the Supreme Court is so obviously defective that it invalidates the entire conclusion. A specific and exclusive tax on state bonds would indeed have the consequences ascribed to it by the court; a general

tax could not possibly have those consequences. A tax on the income of state or municipal bonls as a part of a general income tax would leave everything as it was before the tax. If the operations of state governments were previously not burthened, they would not be burthened by such a tax. If the power of the state to contract was not affected before the imposition of the tax, it would not be affected by the imposition of the tax. The economic situation would be unchanged.

It may be claimed, however, that, even if the preceding argument is valid and even though state and municipal bonds will not suffer in price by being subjected to a general income tax, a special exemption of state and municipal bonds from taxation will enhance their price. Therefore a failure to exempt them might be regarded as virtually tantamount to an attack on the state's credit. This claim is specious, but it is not valid.

In the first place, the actual enhancement of prices due to special exemption will be far less than is usually imagined; for not only will an income tax or an exemption from such a tax have, as pointed out above, no significant influence on the capital value of the security, but the mere fact of the general exemption of all state and municipal bonds would, in itself, tend to minimize even this slight influence. The exemption of the bonds of a particular municipality might well be expected to exert an influence on their price. But in proportion as other municipal bonds in the state, and state and local securities in other states, come to enjoy the same privilege, the advantage would tend to be neutralized. If the exemption were to apply to all state and local bonds, amounting to many hundreds, or perhaps in the near future even thousands, of millions of dollars, we should see the same development which, as explained above, has actually worn away the original advantage attaching to the tax-exempt bonds of New York City. The broader the exemption area, the less the value of the exemption.

The argument that tax exemption is especially needed in times of crisis is thus robbed of most of its force; for if tax exemption has little value under normal conditions, it can have no great value in times of crisis. At such times, indeed, it will have no value; for in crises bonds are almost completely unsalable. The

drop in their price is so great that the question of their taxation or exemption becomes immaterial.

It may be urged, further, that even if the exemption of state securities from a federal income tax were of real advantage to the states, there seems to be no reason why the federal government should confer upon them this advantage. The constitutional inhibition, if it means anything, means only that the national government shall not discriminate against the states by injuring their power to borrow. It does not mean that the national government should discriminate in favor of the states by enhancing their power to borrow. A special exemption of state bonds from a general income tax would, if it increased the market price of these securities, be tantamount to a gift from the national government to the state government. Such a relation, however, is not contemplated by the Constitution. It is not the function or the province of the national government to confer gifts or favors upon the state governments. The states can look after themselves, and all that they have a right to ask from the national government is that there shall be no unconstitutional interference with their powers. Equality under the Constitution they have a right to claim; special favors they have no right to demand.

Moreover, such an exemption of state and municipal bonds would be inconvenient to the national government and unjust to the individual citizen. Federal securities have at times been taxed by the federal government. It may again become desirable that they shall be so taxed; all the important European countries now find it, on the whole, advisable to tax their own securities. If the bonds of the United States were taxed under a general income-tax law, and if at the same time state and municipal bonds were exempt, it will be readily seen that this would in effect be subordinating the credit of the United States to that of the local divisions. Such a contingency can be contemplated only with apprehension. Of still greater importance is the consideration that, if state and local bonds were especially exempt as over against the whole mass of private and corporate securities, the individual citizen would have a just cause for complaint. Not only would it mean an escape from taxation for all those who chose to invest in state or local bonds,

but, if the advantage were at all appreciable, the increasing demand for these state and local bonds would mean such a transfer of investments as to cause a sensible depreciation in the market value of other securities, and the unfortunate possessors of those other securities would have to suffer a loss, the corresponding gain accruing to the happy possessors of the tax-exempt state and local bonds.

Thus, from every point of view, the special exemption of state bonds from a general income tax is indefensible. It would in all likelihood not accomplish the object which it is designed to attain; but in so far as it did accomplish this object, it would create a glaring inequality, inimical alike to the maintenance of the national credit and to the interests of the mass of the individual taxpayers.

III

We come now to the final consideration. Even if it were true, as it is not, that the proposed constitutional amendment empowers the national government to tax the income of state bonds, there are valid reasons to justify such a change in the law. Even if the amendment may be so interpreted as to give the federal government this new power, it ought still to prevail.

On what ground, however, it may be asked, can we defend the immunity of national bonds from state taxation, and at the same time uphold the possible legitimacy of the federal taxation of state bonds? Does not the same principle, the independence of each government within its own sphere, apply in both cases? Let us look into this question.

If we examine the successive legal decisions on the subject, we shall find that there have been three stages in the development of the doctrine that the states may not tax the agencies of federal government. In the case of McCulloch *v.* Maryland, in 1819, the objection was to a special and exclusive state tax on an agency of the federal government; for the tax in question was levied on "all banks, or branches thereof, in the state of Maryland, not chartered by the legislature," and the only

bank at that time fitting the description was the Bank of the United States. In the case of Weston *v.* Charleston, in 1829, the second step was taken by declaring unconstitutional a state or local tax which was indeed not exclusively levied on the instrumentalities of the national government, but which specifically and by name included federal bonds in a list of taxable securities. The third and final stage was reached in the case of Dobbins *v.* Commissioners of Erie County, decided in 1842, in which it was held that a local tax, entirely general in character and making no special mention of government salaries, was nevertheless invalid so far as it affected the salaries of federal officers. And in the same way, a few decades later, in 1862, it was decided in Bank of Commerce *v.* New York City that a state tax on federal bonds was unconstitutional even if the tax were entirely general in character and did not mention federal bonds at all. Thus we have a gradual evolution of the doctrine, from the initial stage of exclusive taxation through that of specific mention to the final stage of general taxation.

On the other hand, in the reverse case of the attempt of the federal government to tax state agencies, there was no such gradual evolution of the doctrine. The theory which had reached its complete formulation in 1842 and in 1862, with reference to state taxation of federal agencies, was now, in 1870, taken over bodily to apply to the federal taxation of state agencies. In the case of Collector *v.* Day it was decided that a general federal income tax was unconstitutional so far as the salaries of state judicial officers were concerned, even though they were not at all specifically mentioned in the law. And in the Pollock case this reasoning was applied to a general federal income tax so far as it reached the income of municipal bonds.

On what grounds, now, can we justify the rule of non-interference with agencies of government in the first set of cases and withhold our approval from its application to the second set of cases? It may at once be conceded that a tax on the agencies of state government which really impairs the operations of state government would be just as obnoxious to the Constitution as a similar state tax on federal agencies. It may further be conceded that a special federal tax on state bonds or on the income of state bonds would be just as indefensible as a similar state

tax on federal bonds. The question at issue, however, is a different one—it is whether the taxation of federal bonds under a general state tax law is to be put in the same category as the taxation of state bonds under a general federal tax law. In my opinion the two cases are not on a par, and for the two following reasons, the one political, the other economic.

The political ground on which a distinction may be drawn between the two cases is this: A state legislature may frequently find it in the interest of the state to follow a policy which is different from that of other states, and which may even be distinctly opposed to that followed in federal legislation. The states, acting through their legislatures, may regard only their peculiar narrow interests and may consider them superior to those of the country as a whole. On the other hand, Congress is composed of representatives from all the states, and in the Senate, in particular, equal voice is given to the wishes of each state. There is hence no likelihood of a federal tax law interfering with the states, except where it is the well-considered opinion of a majority of all the states that the interests of any particular state ought to be subordinated to the welfare of the whole. In other words, while the federal government would, without the restrictions which the Supreme Court has read into the Constitution, have no protection against hostile action on the part of state legislatures, the state governments have, from the very nature of the case, a far greater measure of protection against the acts of Congress.

It must, moreover, not be overlooked that all sound constitutional interpretation should keep pace with the changing needs of political and social life. The conditions which existed when the constitution was framed are no longer existent. At that time the political and economic interests of the separate states were so distinct and the sense of state sovereignty was so strong that it was only with extreme difficulty that a federal government was established at all. During the last century, however, the development of the underlying economic and social forces has created a nation, and this development calls for uniform national regulation of many matters which were not dreamed of by the founders. In all the federal states which have been created during the nineteenth century, under the influence of these

newer economic forces, in Canada, in Germany, in Australia and in South Africa, we find no such problems as those which vex us, because of the greater authority initially granted to the central government. In Canada, for instance, we find just the reverse of our system. With us all powers not expressly conferred upon the federal government are reserved to the states or to the people; in Canada the powers not expressly conferred on the states or provinces are reserved to the federal government. It is idle to say that this centralization of powers, where centralization is needed, is injurious either to democracy or to self-government. There is at least as much true democracy and as much real self-government in Canada and in Australia as there is in the United States. Let us not make a fetich of "self-government," and let us not oppose central authority in those cases where self-government means retrogression rather than progress.

The Supreme Court of the United States has already been influenced by these considerations. In the case of Veazie Bank *v.* Fenno[1] it was held that a federal tax on state bank notes was valid, because of the necessity of upholding a national system of currency. In the recent and very important case of South Carolina *v.* United States[2] it was held that a federal tax on a state dispensary was constitutional. On the other hand it is certain that the Supreme Court would never uphold the validity, without the express consent of Congress, either of a state tax on national bank notes or of a state tax on a federal business or a federal monopoly. In other words, we are gradually working out, in detail, the distinction that Marshall formulated many years ago in McCulloch *v.* Maryland: "The difference is that which always exists and always must exist between the action of the whole on a part and the action of a part on the whole." Sooner or later it will be realized that this distinction applies also as between a state tax on federal bonds and a federal tax on state bonds. Sooner or later we shall outgrow many of the notions of extreme individualism and of exaggerated state rights which dominated the country at the time

[1] 8 Wallace, 533 (1870). [2] 199 U. S. 437 (1905).

of the formation of the Constitution. They are bound to disappear in the United States as they have disappeared in every other great federal republic.

If this political argument does not appeal to those who are still enmeshed in the web of extreme individualism and exaggerated state rights, there remains another argument of an economic character which is of decisive importance. Even though we assume that from the political point of view no distinction ought to be made in the matter of taxation between the state and the national government, it is susceptible of proof that valid economic reasons will justify the distinction between a general state tax on federal bonds and a general federal tax on state bonds. The general state tax to which allusion is made is the general property tax. The general federal tax to which allusion is made is the general income tax. Now a state tax on government bonds, as part of a general property tax, not only is unconstitutional but ought always to remain unconstitutional. State A, which imposes the tax in question, would, of course, from the very nature of the case, tax all other monied capital as well as the capital invested in federal bonds. But its neighbor, state B, might see fit not to impose a general property tax. There are several states in the Union which today do not impose a general property tax. Or, even if state B imposed a general property tax, its methods of assessment might be so lax that it would not reach all other monied capital. Consequently, if state A included government bonds in its taxable general property and actually assessed the bonds, the bonds would undoubtedly be affected in value through the lack of uniformity in the various states. The power of the general government to borrow money might thus be seriously impaired, and this risk would, beyond cavil, constitute a sufficient reason for withholding the power from the states. On the other hand, if the federal government were to impose a general income tax which, under the very terms of the Constitution, must neces-

sarily be uniform[1] throughout the country, the income from state bonds would be reached in precisely the same way as the income from all other monied capital, and, as I have abundantly shown above, there would be no alteration in the value of the bonds and, therefore, no influence exerted on the power of the states to borrow.

The Supreme Court of the United States went off on a wrong tack, not in the case of Dobbins *v.* Commissioners in 1842, but in the case of Collector *v.* Day in 1870. The cases, from the economic point of view, were not on a parity. Had Collector *v.* Day presented a situation like that in McCulloch *v.* Maryland, *i. e.,* had it been a question of an exclusive federal tax comparable to the exclusive state tax, the economic basis of the argument would have been the same. But when Collector *v.* Day attempted to apply by inversion Dobbins *v.* Commissioners—when, in other words, a general federal tax was declared equivalent to a general state tax—the judges were misled by a

[1] It might be claimed that there will be no assurance of uniformtiy, for the constitutional provision as to uniformity specifically applies only to "all duties, imposts and excises." Since the amendment, while changing the method of levying the income tax, in so far as it has been held to be a direct tax, leaves unaltered its nature or appellation as a direct tax, it might be contended that the income tax as a direct tax is not necessarily subject to the constitutional inhibition as to uniformity.

This contention, however, is clearly erroneous. The Constitution gives a double classfication of taxes—one according to their nature, the other according to the mode of levy. According to their nature, taxes are divided into the four classes of direct taxes, duties, imposts and excises. According to the mode of levy, however, taxes are divided into two classes only—those subject to the rule of apportionment and those subject to the rule of uniformity. If, now, the income tax is by constitutional amendment taken out of the first category, it necessarily falls into the second. There is no third category into which it could fall. To assume that an income tax could be levied without uniformity would be to make of the tax neither fish nor flesh—to keep it, as it were, suspended in mid-air between the two solid posts of apportionment and uniformity. These are the only methods contemplated by the Constitution. Every tax, no matter what its application, must be levied in one of these two ways. If the one way is barred by the constitutional amendment, it must necessarily be levied in the other way. To assume that under the amendment we could have anything but a uniform income tax would be to do violence to every rule of constitutional construction.

superficial analogy which had no basis in economic fact. In the same way the Supreme Court erred when, in deciding the first Pollock case, it thought that it was applying the principle involved in Weston *v.* Charleston. Weston *v.* Charleston dealt with a state tax on federal securities; the Pollock case involved the question of a federal tax on state securities. As we have seen, the economic conclusions which apply in the one case do not apply in the other.

In the long run, however, the economic interests of a community must prevail; for law is nothing but the crystallization of economic and social imperatives. Sooner or later, therefore, the underlying fallacy in the more recent decisions of the Supreme Court will be recognized by the court itself, or the mistake will be corrected by constitutional amendment. The law cannot permanently lag behind the economic truth.

Entirely apart, therefore, from any legal or political considerations that might be invoked, an economic analysis shows clearly that the inclusion of state bonds under a general federal tax is a very different thing from the inclusion of federal bonds under a general state tax. Since the economic results are, or may be, so entirely different, the legitimacy of the action of the respective governments is entirely different. From the economic point of view, the states ought not to have the right to tax the bonds of the federal government at all; but the federal government might well be justified in including state bonds in a general income tax. Hence, even if the constitutional amendment were to have the legal consequences which are predicated of it, it ought still to prevail, in order to subserve the best economic interests of the whole country.

IV

In order thoroughly to discuss all the problems raised by the constitutional amendment it would be necessary to go at some length into two further problems: first, to what extent is the taxation of government securities advisable, even by the power that issues them? and, secondly, how far is the general scheme of an income tax in itself to be welcomed ? These matters, how-

ever, would lead us too far astray, and they have, strictly speaking, only an indirect connection with the specific questions that are raised by the amendment. It may be stated, however, that in so far as the question of the taxation of government bonds is concerned, there are good argumetns on both sides, and that this question finally resolves itself into a choice between upholding the credit of the government and maintaining exact impartiality as between individual taxpayers. Most of the Euoprean countries, after a long period of wavering, have now come to the conclusion that the exemption of government securities from the income tax is, on the whole, inadvisable, and they are willing to subordinate the slight advantages which would accrue to the borrowing power of the government to what they conceive to be the far greater benefit of complete uniformity and equality as among the various classes of taxpayers. The tendency throughout the civilized world is away from, and not in the direction of, the exemption of government securities.

So far as the problem of a general income tax is concerned, there is perhaps less room for discussion. Many thoughtful citizens, indeed, may still have their doubts as to the practicability of an income tax and as to the possibility of the United States government creating a really successful income-tax measure. But all these doubts must fade away when the question is presented in all its baldness: "Shall the government of the United States be precluded from even making the attempt to levy an income tax?" To deny to a great empire like the United States the possibility of utilizing so powerful a fiscal engine in times of national stress would be almost equivalent to advocating national suicide. At all events, it amounts to a deliberate decision to put the national government at an enormous disadvantage at the very times when no possible advantage can safely be neglected. To withhold from the government of the United States a power which is possessed by the smallest of its competitors would be a monstrous folly.

Whether an income tax is a desirable supplement to the ordinary tax system of the United States in times of peace is a far-reaching question which need not be discussed in this place. That, after all, is a matter for the legally constituted represen-

tatives of the nation to determine. But surely no patriot can afford to object to conferring upon the United States a power which until recently it was always supposed to possess, and without which its prosperity—nay, even, its very existence—might possibly be menaced. The pending constitutional amendment seeks to secure this result, and its adoption ought not to be impeded by arguments that place upon it an erroneous interpretation and conjure up dangers which a more careful economic analysis shows to be wholly non-existent. The pending constitutional amendment is not only legally defensible and politically innocuous, but it is, above all, economically sound. It is, therefore, from every point of view eminently desirable.

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